No. 98-2043

In The

Supreme Court of the United States

HUNT-WESSON, INC.,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Petition For Writ Of Certiorari To The Court Of Appeal Of California For The First Appellate District

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

California permits a corporation engaged in business in the State to deduct interest as an expense for the purpose of determining its California franchise tax liability. For a corporation engaged in business both in and out of California, the amount of the interest deduction is statutorily determined pursuant to Cal. Rev. & Tax. Code § 24344(b). This statute is designed to close a judicially-acknowledged tax loophole by preventing a corporation from obtaining a double tax benefit by investing its own capital in nonbusiness activities which generate dividends and interest exempt from California taxes, while concurrently avoiding California taxes by operating its business on borrowed funds, thereby generating an interest expense deduction. The statute attempts to curtail this practice by prescribing an ordering rule for correlating, or matching, a corporation's interest expense with the category of income, including nonbusiness dividend and interest income, to which it relates. Against this background, the following question is posed:

> Whether the California Court of Appeal correctly concluded that the provisions of Cal. Rev. and Tax. Code § 24344(b) provide a constitutionally valid method of assigning interest expense to the business income of Hunt-Wesson under the Due Process Clause and Commerce Clause for purposes of determining its California franchise tax liability.

LIST OF PARTIES

Respondent, Franchise Tax Board, accepts petitioner Hunt-Wesson, Inc.'s version of the List of Parties as stated in its Petition for Writ of Certiorari.

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RESPONDENT'S BRIEF IN OPPOSITION

Respondent Franchise Tax Board ("Board") respectfully requests that this Court deny the Petition for Writ of Certiorari ("Petition") of petitioner Hunt-Wesson, Inc. ("Hunt-Wesson").

OPINIONS BELOW

The Board accepts Hunt-Wesson's statement of the Opinions Below as contained in its Petition and as reproduced at App. 1a-34a of the Petition.

STATEMENT OF JURISDICTION

The Board accepts Hunt-Wesson's statement of Jurisdiction as contained in its Petition.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Board accepts Hunt-Wesson's statement of the Constitutional and Statutory Provisions Involved as contained in its Petition and as reproduced at App. 35a-38a of the Petition. Additional statutory provisions are contained in App. B-1 – B-4 of the Board's Opposition.

STATEMENT OF THE CASE

This is an action for refund of California franchise taxes collected from Hunt-Wesson, a corporation engaged

in business throughout the world, including California, during fiscal years ended 1980 through 1982 ("years in issue"). Hunt-Wesson seeks a refund of $1,523,462 and applicable interest thereon.

A. California's method of taxing multistate corporations

California imposes a franchise tax on every corporation doing business within the State. Cal. Rev. & Tax. Code § 23151. When a corporation derives its income from sources both in and out of California, its franchise tax is measured by that portion of its net business income attributable to sources within the State and the amount of nonbusiness income allocated to the State. Cal. Rev. & Tax. Code § 25101.

California taxes the business income of multistate corporations engaged in a unitary business in the State by applying a standard apportionment formula, one by which income is apportioned to California by reference to the total aggregate business income of the entire group of corporations which comprise the unitary business.[1] In apportioning the amount of a corporation's business income among the various states in which it does business, California follows the Uniform Division of Income for Tax Purposes Act (UDITPA). Cal. Rev. & Tax. Code § 25120 *et seq.* Under UDITPA, a distinction is drawn

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[1] This Court has characterized a unitary business as a functionally integrated enterprise whose parts are characterized by substantial mutual interdependence and a flow of value. *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 178-179 (1983).

between business income and nonbusiness income.[2] Generally speaking, business income and expenses are apportioned among the various states according to the standard formula. Cal. Rev. & Tax. Code §§ 25121 & 25128. By contrast, nonbusiness income and expenses are not subject to apportionment by formula but instead are allocated entirely to a single state. Cal. Rev. & Tax. Code §§ 25123-25127. Nonbusiness income in the form of dividends and interest is generally allocable to the state where the taxpayer is commercially domiciled. *See* Cal. Rev. & Tax. Code §§ 25123 & 25126.

B. Cal. Rev. & Tax. Code § 24344(b)

Cal. Rev. & Tax. Code § 24344(b) allows for California franchise tax purposes a deduction for interest paid or accrued on indebtedness incurred by a corporation whose income is determined by the standard apportionment formula contained in section 25101.[3] The statute also

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[2] Business income is defined as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Cal. Rev. & Tax. Code § 25120(a). Nonbusiness income is defined as all income other than business income. Cal. Rev. & Tax. Code § 25120(d).

[3] During the years in issue, section 24344 provided as follows:

> 24344. Interest.
>
> (a) Except as limited by subsection (b), there shall be allowed as a deduction all interest paid or accrued

provides an ordering rule by which the amount of deductible interest expense to be taken against business income apportioned to California is calculated.

Section 24344(b) by its terms applies to a corporation doing business both in and out of California and whose California business income is determined by apportionment. The statute first allows such a corporation to deduct its interest expense against its business income to the extent that it has realized interest income subject to allocation by formula (i.e., business interest income). The statute then allows an additional interest expense deduction up to the amount of any remaining interest expense which exceeds interest and dividend income not subject to formula allocation (i.e., nonbusiness interest and dividend income). Lastly, the statute allows the amount, if any, of the remaining interest expense to be deducted against nonbusiness interest and dividend income (except

during the income year on indebtedness of the taxpayer.

(b) If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under Section 24402) not subject to allocation by formula.

for dividends deductible under Cal. Rev. & Tax. Code § 24402).[4]

C. Cal. Rev. & Tax. Code § 24344(b) as applied to Hunt-Wesson

Hunt-Wesson is a corporation incorporated in Delaware and domiciled in Illinois. A diversified food company producing a wide range of food and food-related products and services for worldwide markets, Hunt-Wesson is engaged in a unitary business both in California and throughout the world.

During each of the years in issue, Hunt-Wesson owned a number of dividend-paying subsidiaries, none of which was a member of Hunt-Wesson's unitary business group of corporations. These nonunitary subsidiaries paid dividends to Hunt-Wesson in an amount approximating $27 million, $29 million and $19 million respectively during each of the years in issue. Hunt-Wesson reported all of these dividends on its California franchise tax returns as nonbusiness income not subject to tax by California.

Hunt-Wesson also incurred interest costs from loans in the approximate amounts of $80 million, $55 million and $137 million respectively for each of the years in issue. All of the above-stated interest expense was reported as business interest expense and claimed as a

[4] Section 24402 provides for a deduction to the recipient of dividends declared from income which has been "included in the measure of the taxes imposed . . . upon the taxpayer declaring the dividends."

deduction by Hunt-Wesson on its California franchise tax returns for the years in issue.

Following an audit, and pursuant to Cal. Rev. & Tax. Code § 24344(b), the Board allowed Hunt-Wesson to deduct its interest expense against its California business income to the full extent of its business interest income and the full extent to which the interest expense exceeded the nonbusiness dividends. The remaining interest expense was allowed as an offset against the nonbusiness dividends, which were assigned to the state of Hunt-Wesson's commercial domicile.

The Board assessed a tax deficiency against Hunt-Wesson for each of the years in issue. Hunt-Wesson paid the deficiency and filed an administrative claim for refund with the Board. The claim for refund was denied.

D. Adjudication of the federal questions in the proceedings below

Hunt-Wesson challenged the constitutionality of Cal. Rev. & Tax. Code § 24344(b) in the California Superior Court on the grounds that it violated the Due Process Clause, Commerce Clause and Equal Protection Clause of the United States Constitution. The trial court rendered judgment in favor of Hunt-Wesson on each of these grounds. App. 14a-34a of Petition.

The Board appealed. In a decision not certified for publication, the California Court of Appeal held that section 24344(b) did not violate any provision of the United States Constitution and reversed the judgment of the trial court. App. 1a-13a of Petition.

Hunt-Wesson's petition for review of the Court of Appeal's decision to the California Supreme Court was denied without comment. App. 43a of Petition.

REASONS FOR DENYING THE PETITION

This Court should deny review for several reasons. First, the California Court of Appeal's unpublished decision (App. 1a-13a of Petition) carries no precedential weight beyond the limits of this case. As such, the questions of law presented here, already judicially resolved twice by appellate courts in favor of the Board, lack sufficient national importance to warrant a third appellate review by this Court. Second, the Court of Appeal's decision is consistent with a line of decisions of this Court that a state (or other taxing jurisdiction) bears no obligation to allow a tax deduction for an expense incurred in the earning of income which that state is not permitted to tax. Finally, Cal. Rev. & Tax. Code § 24344(b) does not violate the Commerce Clause by any discrimination against taxpayers either on the basis of domicile or the extent of in-state activity. Section 24344(b) applies uniformly to domestic and foreign corporations alike without discrimination. As the Court of Appeal correctly held, the deductibility of interest expense under section 24344(b) is "determined not by the corporation's domicile, but by the character of the income attributable to that expense."[5] App. 10a of Petition.

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[5] The issue raised in this Petition has also been raised in *F. W. Woolworth Co. and Kinney Shoe Corp. v. Franchise Tax Board*, No. 98-1967 (Petition for Writ of Certiorari filed June 7, 1999).

I. THE ISSUE PRESENTED TO THIS COURT LACKS THE SUFFICIENT NATIONAL IMPORTANCE TO WARRANT A GRANT OF CERTIORARI

Hunt-Wesson fails to state a compelling case that the constitutionality of Cal. Rev. & Tax. Code § 24344(b) is of such national urgency as to warrant review by this Court.

First, Hunt-Wesson overstates both the significance and potential ramifications of the Court of Appeal's decision for taxpayers in California and in other states of the Union. Publication of the decision was denied by both the Court of Appeal and the California Supreme Court and is not a part of the official case reports of California. As such, under California law, the decision cannot "be cited or relied on by a court of a party in any other action or proceeding. . . . " Cal. Rules of Court, Rule 977(a). Any potential impact attending to the decision as controlling legal authority thus does not extend beyond the limits of this case.

Second, Hunt-Wesson's contention that the Court of Appeal's validation of section 24344(b) will "pave the way" for other states to enact similar statutes is unfounded. The provisions of section 24344(b), as applicable to the years in issue, have been a part of California's tax landscape for over 40 years (ch. 543, p. 1600, § 1, 1957 Cal. Legis.). The California Supreme Court has previously reviewed and upheld the provisions of section 24344(b) as valid. *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*, 7 Cal.3d 544, 498 P.2d 1030 (1972) (*"Pacific Telephone"*). Yet, there is no evidence before this Court that any of the 49 other states currently utilizes an identical statutory provision. The belief that any state would now choose to

enact such a statute as a result of an unpublished decision carrying no precedential value is doubtful at best.

Third, the alleged impact of the Court of Appeal's decision on multistate taxpayers engaged in business in California is less pervasive than Hunt-Wesson suggests. Section 24344(b) has only limited application to those California taxpayers potentially affected by its terms. Only those multistate corporations doing business in California which incur interest expense in an amount exceeding their business interest income and concurrently realize nonbusiness income during the same tax period trigger the interest offset provisions of the statute. Where a corporation's interest expense is equal to or less than its business interest income, or where nonbusiness income is not realized, no interest is offset, and the full amount of the interest expense is deductible.

Finally, while the constitutionality of any state statute is an important issue to California, the Court of Appeal's decision resolved this question in a manner fully consistent with existing constitutional jurisprudence. This is reflected in the Court of Appeal's recommendation against publication of its decision on the grounds that it "(1) establishes no new rule of law, nor does it alter or modify an existing rule; (2) involves no legal issue of outstanding public interest; and (3) does not criticize existing law." App. A-1 of Opposition. The Court of Appeal's characterization of its decision stands in stark contrast to the selective considerations governing discretionary review on certiorari as contained in Rule 10(c). In any event, as will be shown below, a grant of certiorari would only confirm what this Court has repeatedly

stated: a taxing jurisdiction is not constitutionally prohibited from requiring a taxpayer to pay its fair share of expenses for earning income which that jurisdiction is barred from taxing.

In short, this case lacks the national significance to warrant this Court's extended attention. The Court of Appeal's decision has no binding effect on California taxpayers other than Hunt-Wesson, and legislatures in other states have demonstrated little, if any, interest in emulating California's statutory scheme. To the extent, if any, that an important question of law is presented, the Court of Appeal's decision gave full and thorough consideration to the issue and (as will be shown below) rendered judgment in a manner consistent with this Court's previous decisions and with fundamental principles of tax and constitutional law. A grant of certiorari would serve no purpose other than to require this Court to undertake a third review of a tax expense statute which two appellate courts have refused previously to declare unconstitutional.

II. THE CALIFORNIA COURT OF APPEAL'S DECISION IS CONSISTENT WITH THE SETTLED DECISIONS OF THIS COURT

A. Cal. Rev. & Tax. Code § 24344(b) Does Not Impose a State Tax on Tax-Exempt Income In Violation of the Due Process Clause

California's consideration of Hunt-Wesson's nonbusiness dividend income in the assignment of interest expense to business income under Cal. Rev. & Tax. Code § 24344(b) does not run afoul of this Court's proscription

against a state's attempt to tax constitutionally exempt dividend income received from nonunitary subsidiaries. The statute makes no attempt to tax income, either directly or indirectly, assigned outside of California. Rather, it seeks simply to ensure that a corporation engaged in business in California pays its fair share of taxes by rationally correlating interest expense to business income subject to California tax in an orderly fashion.

When a corporation engaged in business both in and out of California incurs an indebtedness and concurrently holds nonbusiness investments which generate income taxable outside of California, the question arises as to what extent, if any, the corporation should be allowed to deduct its interest costs for state tax purposes. If a full deduction is allowed, the corporation stands to gain a tax windfall by taking its full interest deduction against its business income, while at the same time shielding its nonbusiness investment income from state taxation. This inquiry stems from the judicially-recognized existence of an economic relationship between the interest costs of indebtedness and the generating of nonbusiness income, one which allows a corporation to finance its business operations on borrowed capital while at the same time earning exempt nonbusiness income by investing its own capital.

California permits a corporate taxpayer to deduct from gross income all interest paid or accrued within the taxable year on indebtedness as an expense incurred in the production of that income to determine taxable income. Cal. Rev. & Tax. Code § 24344(a). However, no deduction is allowed for expenses which are allocable to

income not subject to tax by the State. Cal. Rev. & Tax. Code § 24425.

The issue presented in this case arises where a corporation doing business in California seeks to reduce its state tax liability by claiming a deduction for interest costs which include expenses related to the production of exempt nonbusiness income. The difficulty from California's standpoint lies in determining as a practical matter the extent to which interest expense is attributable to business income as opposed to nonbusiness income not taxable by the State.

This problem stems from the basic notion that money, by its very nature, is fungible and easily subject to manipulation. For this reason, interest costs cannot be readily traced to the specific classification of income which is generated from both business and nonbusiness activities. Typically, as in this case, a corporation will claim the entire amount of its interest costs against taxable business income and allocate none to its nonbusiness income. As a result, while the nontaxable gains associated with the interest costs are not taxed at all, the interest costs themselves are deductible dollar for dollar against income that would be otherwise fully taxable but for the deduction.

To close such a loophole which essentially permits a corporation to get something for nothing, California deemed it necessary to devise a method to correlate, or match, a corporation's interest costs to the type of income to which it relates.[6] The enactment of section 24344(b)

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[6] Hunt-Wesson erroneously claims at footnote 7 of its Petition that what remains after a corporation offsets its interest expense by the amount of its interest income subject to allocation by formula under section 24344(b) constitutes "interest expense attributable to business income." Under the statute, the remaining interest expense is correlated to business income only to the extent that it exceeds nonbusiness income (interest and dividend income not subject to allocation by formula). To the extent that the interest expense is equal to or less than nonbusiness income, it is deductible against nonbusiness income. In this manner, only interest expense assigned to business income is deductible against business income for California tax purposes.

constitutes an attempt by the California Legislature to address the complex issue of interest allocation in a rational manner.

In defining the limits to which a tax exemption may be afforded to income not subject to tax, this Court has repeatedly declared that the immunity from taxation need not be total, but may instead be limited by charging such nontaxable income its fair share of related expenses. *See Denman v. Slayton*, 282 U.S. 514 (1931) (federal tax statute permitting deduction of interest expense on indebtedness except as to indebtedness incurred to purchase or carry tax-exempt securities upheld as constitutional and reasonable to close tax loophole); *Helvering v. Independent Life Ins. Co.*, 292 U.S. 371 (1934) (federal tax provisions allowing for deduction of depreciation and expenses of buildings owned by life insurance companies but only on condition that company include in gross income the nontaxable rental value of the space which it occupied upheld as not an improper tax on the tax-exempt rental value, but rather a permissible "apportionment of expenses"); *United States v. Atlas Life Ins. Co.*, 381

U.S. 233 (1965) (affirmed holdings in *Denman* and *Independent Life* that "the tax laws may require tax-exempt income to pay its way"); *First Nat. Bank v. Bartow Cty. Tax Assrs.*, 470 U.S. 583 (1985) (state statute limiting deduction of tax-exempt government obligations in determining bank's net worth on which tax was based upheld as constitutional).[7]

The Court of Appeal's decision upholding the constitutional validity of section 24344(b) is fully consistent with this line of authority. Similar to this Court's decisions, section 24344 is premised on the idea that a state bears no obligation to allow a deduction for an expense relating to dividend income which that state is barred from taxing. The statute attempts only to fairly correlate that portion of interest expense which is attributable to the tax-exempt income.

In *Pacific Telephone*, 7 Cal.3d at 551-52, 498 P.2d at 1036, on which the Court of Appeal's decision principally rests, the California Supreme Court correctly acknowledged the economic relationship between interest costs

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[7] Hunt-Wesson's reliance on *National Life Ins. Co. v. United States*, 277 U.S. 508 (1928), at page 18 of its Petition, to support its claim of indirect taxation is misplaced. That case involved the reduction of a reserve deduction which was "unrelated" to the receipt of nontaxable municipal bond income. By contrast, section 24344(b) is premised on the notion that interest expense is offset because it is **economically related** to the receipt of nonbusiness dividend and interest income. Furthermore, unlike the taxpayer in *National Life*, Hunt-Wesson "was not in effect required to pay more upon [its] taxable receipts than was demanded of others who enjoyed like incomes solely because [it] was the recipient of [nontaxable income]." *Denman*, 282 U.S. at 519.

and dividend income not taxable by California which section 24344(b) was designed to address. The Court observed that inasmuch as section 24344(b) applies only to a corporation that engages in business both in and out of California, both income and expenses must be apportioned to sources within the State and sources outside the State where the corporation is engaged in activities. *Id.* at 555, 498 P.2d at 1038. The Court's conclusion that section 24344(b) rationally apportions deductions to their proper income source by the measure of nontaxable income is fully consistent with this Court's decisions which permit taxpayers to be held accountable for expenses attributable to the production of such income.

Furthermore, the California Supreme Court in *Pacific Telephone* expressly rejected the notion that the inclusion of nontaxable dividends in the section 24344(b) calculation is tantamount to the indirect taxation of such dividends. *Id.* at 555, 498 P.2d at 1038. That the statute operates to increase Hunt-Wesson's California taxable income to the extent that it receives nonbusiness dividends does not mean that nontaxable income is being taxed. On the contrary, the statute simply operates to foreclose to a corporation such as Hunt-Wesson the opportunity to eliminate California taxes by deducting interest expenses economically related to its nonbusiness dividend income, on a dollar for dollar basis, against business income, thereby resulting in a double tax benefit.

That Hunt-Wesson made no direct operating loans to its nonunitary subsidiaries during the years in issue does nothing to invalidate the application of section 24344(b) to this case. This is so because even when borrowed

funds are used exclusively for business purposes, the mere act of borrowing will necessarily make available other funds which Hunt-Wesson may utilize for nonbusiness purposes. Indeed, it is at least debatable whether a corporation may properly treat borrowed money as truly borrowed for business purposes when it has funds of its own invested in nonbusiness activities which, if used, would eliminate the necessity of borrowing and thus eliminate the interest expense. Put differently, interest expense may be properly viewed as the cost of obtaining income from nonbusiness investments to the extent that the two are equivalent regardless of whether the borrowed money was or was not used for business purposes.[8]

This Court's decisions, cited above, have repeatedly declared that statutes, similar to section 24344(b), which correlate expenses between taxable income and nontaxable income in order to determine the extent to which a deduction should be allowed are constitutionally permissible. A corporation that borrows money to enable it to earn nonbusiness income through investments is not constitutionally entitled to pay less California tax than a corporation which owns no such investments. Merely because Hunt-Wesson is constitutionally protected in California from taxation of its nonbusiness income does not mean that California is barred from apportioning its

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[8] Given the fungible nature of money, it cannot be readily demonstrated that Hunt-Wesson incurred its interest expense during the years in issue exclusively for business purposes. The borrowed funds generating the interest expense inevitably supported the activities of the corporate office, which conducted activities relating to both unitary and nonunitary subsidiaries.

expenses so as to ensure that only that amount of expense attributable to taxable income is permitted to reduce taxable income.[9] Section 24344 does nothing more than require Hunt-Wesson's nonbusiness income to pay its own way. As such, it is fully consistent with the Due Process Clause. A grant of certiorari to affirm what has long been a fundamental principle of taxation law is unwarranted.

B. Section 24344(b) Does Not Discriminate Against Interstate Commerce

California's consideration of Hunt-Wesson's nonbusiness dividend income in the measure of the interest

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[9] Hunt-Wesson's claim at footnote 14 of its Petition that nonbusiness interest expense is excluded as a deduction before section 24344(b) is applied appears to be based on its interpretation of California state tax form Schedule R-5, Form 100. Clerk's Transcript ("CT") p. 58. This form instructs the taxpayer to identify and subtract its nonbusiness interest expense prior to determining the amount of interest expense attributable to business income. However, given the rationale of section 24344(b), any nonbusiness interest expense excluded from the statutory calculation refers only to that expense which is *directly* traceable to a specific item of nonbusiness income.

In any event, nothing in the statutory provisions of section 24344(b) calls for the elimination of nonbusiness interest expense as part of the calculation of interest expense deduction. *See Pacific Telephone, supra*, at 549-550, 498 P.2d at 1034-1035. Since Hunt-Wesson's challenge is directed to the constitutionality of section 24344(b) itself, and not to the provisions of Schedule R-5, any confusion contained in this form has no bearing on the outcome of this case. The amount of tax in dispute here is unaffected by any such ambiguity, and Hunt-Wesson does not contend otherwise.

expense attributable to business income under Cal. Rev. & Tax. Code § 24344(b) furthermore does not violate the Commerce Clause by favoring in-state activity over out-of-state activity.

First, section 24344(b) does not assign interest expense to nonbusiness income taxable outside of California in all cases in which a multistate corporation receives dividends from nonunitary subsidiaries. The challenged provisions of the statute come into play only in those instances where a corporation's interest expense exceeds its business interest income. Where the corporation's interest expense does not exceed or is equal to its business interest income, a full interest expense deduction is allowed regardless of the amount of nonbusiness income realized and regardless of the corporation's state of domicile.

Second, Hunt-Wesson's claim of discrimination based on domicile is unfounded. Discrimination, for constitutional purposes, is prohibited only as to taxpayers which are similarly situated. *See General Motors v. Tracy*, 519 U.S. 278 (1997) (upholding Ohio law which imposed sales and use tax on purchases of natural gas from out-of-state companies, but not on purchases of natural gas from in-state companies, as not facially discriminatory). In this case, the constitutionally relevant basis for comparison lies not between domiciled and nondomiciled corporations, but rather between corporations that elect to borrow money while also earning nonbusiness interest and dividends not subject to California tax and corporations that borrow money without also earning such nonbusiness interest and dividends. Under section 24344(b), California strives to ensure that a corporation that invests its

own capital in nonbusiness activities while operating on borrowed funds and a corporation that operates on its own capital and owns no such nonbusiness investments are similarly situated for state tax purposes. In this manner, the amount of deductible interest expense does not discriminate against non-domiciled corporations – the amount of the interest expense assigned to nonbusiness income is the same regardless of whether the corporation is domiciled in California – but simply places the two corporations on an equal footing. Section 24344(b) seeks not to encourage in-state activity, but rather to discourage a corporation from electing to use its capital for nonbusiness purposes while operating its business on borrowed monies, thereby generating for itself a tax windfall.[10]

Third, even assuming that Hunt-Wesson's chosen basis for comparison were proper, no constitutionally cognizable "discrimination" exists here. Whether a state tax is discriminatory "requires an examination of the state's whole tax structure." *Washington v. United States*, 460 U.S. 536, 542 (1983). Inasmuch as section 24344(b) applies only to a corporation engaged in a unitary business both in and out of California, it is only appropriate that its constitutional validity be considered within the context of the unitary business principle of income apportionment.

As such, section 24344(b) cannot be viewed as an isolated tax expense statute, but rather as part of an

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[10] Alternatively, had Hunt-Wesson qualified the dividends from its nonunitary subsidiaries as business income, all of its interest expense would be attributable to business income and fully deductible in California regardless of domicile.

overall tax scheme by which Hunt-Wesson's net income is apportioned pursuant to a judicially-approved formula among all of the states in which it conducts business. As a member of a unitary business, Hunt-Wesson's taxable California income is determined by calculating the income and expenses of its entire business worldwide and then apportioning by formula a portion of that net income to the State. The apportionment of Hunt-Wesson's total net income from all sources ensures that only a fair share of its interest expense is being attributed to California.

For apportionment purposes, it is not appropriate to consider interest expense as a state-specific expense. Here, viewing Hunt-Wesson as part of a unitary group which is liable for taxes in all states in which it does business, the total tax of the group does not depend on their various states of domicile.[11] Just as Hunt-Wesson's revenue is derived from a unitary business and thus not confined to a single state, so too the costs of producing this revenue are also unitary in nature. Accordingly, when California attributes a share of Hunt-Wesson's interest expense as a deductible cost of a unitary business

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[11] Unlike the statutes struck down in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996) and the other cases on which Hunt-Wesson relies, section 24344(b) is not discriminatory by its terms and does not facially distinguish between domestic and foreign corporations. Any differentiation in treatment is not the result of domicile, but of the character of the income which is attributable to the interest expense. The distinction afforded between business and nonbusiness income is one that is mandated by constitutional jurisprudence. *See ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982).

under section 24344(b), the resulting net figure is a unitary one, which may legitimately be apportioned among the states by formula. *See Amerada Hess v. Director, Div. of Taxation, N. J. Dept. of Treasury*, 490 U.S. 66, 74 (1989).

In the absence of distinctive issues, the anti-discrimination principle of the Commerce Clause "has not in practice required much in addition to the requirement of fair apportionment." *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 171 (1983). Thus, the substantive provisions of a tax do not have a discriminatory effect if the tax is fairly apportioned. *See Trinova Corp. v. Michigan Treasury Dep't*, 498 U.S. 358, 384-387 (1989).

When section 24344(b) is viewed in the context of apportionment of both income and expenses, it is evident that the statute favors neither California domiciliaries nor nondomiciliaries. Section 24344(b) does not prevent a multistate corporation from recognizing the full benefit of each dollar of interest expense which it has incurred. Rather, it simply assigns that interest expense to income attributable to other states in such a manner as to more accurately reflect the true nature and source of that expense. Fair apportionment operates to limit the territorial reach of state power by requiring that the state's tax base corresponds to the taxpayer's in-state presence. Because income is fairly apportioned in California, section 24344(b) neither imports revenue nor exports burdens to other states. The assignment of interest from one

state to a more appropriate state is all that is occurring. That is not discrimination.[12]

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[12] Hunt-Wesson's Commerce Clause argument is not enhanced by its claim at footnote 8 of its Petition that section 24344(b) also favors in-state over out-of-state activity by virtue of the application of section 24402. This statutory deduction is intended "to avoid double taxation at the corporate level of income which has already been subjected to California taxation in the hands of the dividend-declaring corporation." *Pacific Telephone*, 7 Cal.3d at 548, n. 4, 498 P.2d at 1034, n. 4. Inasmuch as the dividend-producing income has already been taxed in California, no advantage is afforded to California subsidiaries over foreign subsidiaries. The exemption does nothing more than compensate for the earlier taxation of the dividend-producing income by California, thereby eliminating the chance that such income might be subjected to taxation more than once.

In reality, Hunt-Wesson's complaint is directed not at section 24344(b) but rather at the provisions of section 24402. The exclusion of section 24402 dividends from the section 24344(b) calculation merely reflects the fact that interest expense relating to the production of such nontaxable dividends is denied separately as a deduction by virtue of section 24425, which proscribes the deduction of any expense allocable to income not taxable by California. *See Great Western Financial Corp. v. Franchise Tax Bd.*, 4 Cal.3d 1, 479 P.2d 993 (1971). For this reason, the amount of a corporation's interest expense which correlates to such nontaxable income, as measured by the section 24402 dividends, is properly not taken into account again for purposes of section 24344(b).

CONCLUSION

For all of the foregoing reasons, the petition for writ of certiorari should be denied.

Respectfully submitted,

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August 19, 1999

APPENDIX A

State of California
COURT OF APPEAL
First Appellate District
Division Four
303 Second Street, Suite 600 – South
San Francisco, CA 94107

January 8, 1998

The Honorable Ronald M. George
Supreme Court of California
Marathon Plaza, South Tower
303 Second Street, Suite 800
San Francisco, CA 94107

Re: Hunt-Wesson v. Franchise Tax Board, A079969

Dear Justice George:

We have received the enclosed letter requesting publication of our opinion, filed December 11, 1998, in the above case. A copy of our opinion is also enclosed. This court denied the request for publication. In accordance with the provisions of rule 978, California Rules of Court, the request is transmitted for your consideration.

We recommend that the request for publication be denied. The opinion (1) established no new rule of law, nor does it alter or modify an existing rule; (2) involves no legal issue of outstanding public interest; and (3) does not criticize existing law. (Cal Rules of Court, rule 976(b).)

Very truly yours,

/s/ William R. McGuiness
WILLIAM R. MCGUINESS
Presiding Justice

APPENDIX B

RELEVANT SECTIONS OF THE CALIFORNIA REVENUE & TAXATION CODE

§ 24425. Items allocable to income not taxed

Any amount otherwise allowable as a deduction which is allocable to one or more classes of income not included in the measure of the tax imposed by this part, regardless of whether such income was received or accrued during the income year.

§ 25101. Derivation from domestic and foreign sources; measure of tax apportionment

When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120). However, any method of apportionment shall take into account as income derived from or attributable to sources without the state, income derived from or attributable to transportation by sea or air without the state, whether or not the transportation is located in or subject to the jurisdiction of any other state, the United States or any foreign country.

If the Franchise Tax Board reapportions net income upon its examination of any return, it shall, upon the written request of the taxpayer, disclose to it the basis upon which its reapportionment has been made.

§ 25123. Allocation of nonbusiness income

Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided in Sections 25124 through 25127 of this act.

§ 25124. Net rents and royalties

(a) Net rents and royalties from real property located in this state are allocable to this state.

(b) Net rent and royalties from tangible personal property are allocable to this state:

(1) If and to the extent that the property is utilized in this state, or

(2) In their entirety if the taxpayer's commercial domicile is in this state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

(c) The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the income year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the income year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, tangible personal property is utilized in the

state in which the property was located at the time the rental or royalty payor obtained possession.

§ 25125. Capital gains and losses

(a) Capital gains and losses from sales of real property in this state are allocable to this state.

(b) Capital gains and losses from sales of tangible personal property are allocable to this state if:

(1) The property had a situs in this state at the time of the sale, or

(2) The taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.

(c) Except in the case of the sale of a partnership interest, capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

(d) Gain or loss on the sale of a partnership interest is allocable to this state in the ratio of the original cost of partnership tangible property in the state to the original cost of partnership tangible property everywhere, determined at the time of the sale. In the event that more than 50 percent of the value of partnership's assets consist of intangibles, gain or loss from the sale of the partnership interest is allocated to this state in accordance with the sales factor of the partnership for its first full tax period immediately preceding the tax period of the partnership during which the partnership interest was sold.

§ 25126. Interest and dividends

Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state.

§ 25127. Patent and copyright royalties

(a) Patent and copyright royalties are allocable to this state:

(1) If and to the extent that the patent or copyright is utilized by the payor in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this state.

(b) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located.

(c) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located.

APPENDIX C

RELEVANT RULES OF THE CALIFORNIA RULES OF COURT

Rule 977. Citation of opinions

(a) [Unpublished opinions] An opinion of a Court of Appeal or an appellate department of the superior court that is not certified for publication or ordered published shall not be cited or relied on by a court or a party in any other action or proceeding except as provided in subdivision (b).

(b) [Exceptions] Such an opinion may be cited or relied on:

(1) when the opinion is relevant under the doctrines of law of the case, res judicata, or collateral estoppel; or

(2) when the opinion is relevant to a criminal or disciplinary action or proceeding because it states reasons for a decision affecting the same defendant or respondent in another such action or proceeding.

(c) [Citation procedure] A copy of any opinion citable under subdivision (b) or of a cited opinion of any court that is available only in a computer-based source of decisional law shall be furnished to the court and all parties by attaching it to the document in which it is cited, or, if the citation is to be made orally, within a reasonable time in advance or citation.